Investor Preference And Promoter's Ownership Pattern In Graded IPOs Of India

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ABSTRACT

SEBI, the Indian securities market regulator, has set a unique example for the entire world by introducing IPO grading in India in 2006 on an optional basis, and further mandating it from May 2007. The purpose of this grading was to provide retail investors with a ready-made assessment of the fundamental quality of the issuer of an IPO, so that they could make a better and informed investment decision in an era of information overload. Grading of IPOs is subject to severe criticism. Critics question efficacy and effectiveness of this process. However, the findings of this paper suggest that IPO grading does influence investor preference and demand. Further, strong negative effect on post-issue promoter's ownership holding is noted. The paper infers that all investor classes, including retail investors, benefit from IPO grading.

Keywords: IPOs, IPO Grading, Investor's Preference, Oversubscription, Promoters' Holding
JEL Classification: G11, G14, G15, G18, G32

INTRODUCTION

Grading of initial public offers (IPOs, henceforth) in India is a unique practice worldwide. Securities and Exchange Board of India (SEBI, henceforth) after long deliberations introduced it in April 2006 on an optional basis. Later, effective from May 2007, it was made mandatory. This practice aimed to reduce the information asymmetry among the retail (small or individual) investors (or the less-informed) and the high-end investors (the well-informed) comprising of institutions and individuals. This step of SEBI was in its pursuit to safeguard the interests of retail (small) investors. The Indian IPO market is different from the rest of the markets of the world due to the following reasons :

1) It involves a large number of retail (small) investors (according to SEBI, individuals investing up to ₹ 1lakh are qualified as Retail Investors), which more-often, are more than 99 percent of the total applicants.

2) The levels of oversubscription are way too high and can go beyond 100 times of the size of the issue.

3) The poor financial literacy of the small investors results in unsophisticated investment decisions.

4) A negligible number of IPOs get cancelled or withdrawn. Earlier, there was no method to stop dubious entrepreneurs from raising funds from the market and vanish afterwards (Deb and Marisetty, 2008).

Reference may be sought to the case of vanishing companies / fly-by-night operators of 1992-96 during post-CCI abolishment. "Nothing has been done till date to apprehend the culprits due to voids in our regulatory and institutional framework" (Bombay Stock Exchange President, Mr. J. C. Parikh was quoted in a leading financial newspaper, Financial Express published on the 20th December, 1998). In all such cases, only the retail investor is the worst sufferer. “The unsophisticated investors either do not read the disclosure documents or lack the analytical sophistication to understand them. Furthermore, inferior investment decisions may occur due to the limited information-processing capabilities of lay investors, and the 'information overload' produced by the information disclosure” (Jain and Sharma, 2008). Retail investors often follow the 'herd mentality' in their investment decisions and ignore the advice of the professional brokers. Most investors remain dissatisfied with their brokers and rely on their peer group or independent decisions.

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With this background, SEBI started consultations with Credit Rating Agencies (CRAs, henceforth) to work out the framework for equity grading. Other markets of the world are closely monitoring the effect of this process. It is a unique case where SEBI has set a precedent for other markets. According to SEBI, "There are some variants of the product in other markets, for presale equity reports done by equity broking houses. However, no regulator has initiated ratings of the IPOs in any part of the world" (Saha, 2006).

❖ **Criticism of IPO Grading :** Critics are skeptical on the practical results of IPO grading. It suffers from some serious reservations. For one, equity being a 'risk investment', it is difficult to contain all risk into grades, specifically when they influence investors' decision. Furthermore, unlike debt instruments, equity instruments do not have well defined cash flows and time horizons. Further, to make things complicated, market participants do not accept the rating at its face value. Therefore, IPOs with the same grade will have different prices and will deliver different performances. Investors evaluate stocks primarily based on prices, whereas IPO grading has nothing to do with the price of a stock. It is not a 'recommendation' to buy or not to buy a stock, but only a hint on the quality of the issuing company. "As the IPO grading does not take cognizance of the price of the security, it is not an investment recommendation. Rather, it is one of the inputs for the investor to aid in the decision making process. All other things remaining equal, a security with stronger fundamentals would command a higher price" (Saha, 2006). Further, there is no proof available on IPO Grading reducing the information asymmetry. Therefore, no clear evidence is available on preference given towards IPO Grading by the retail investors. CRAs are independent agencies and are not accountable to anyone - the investor, the regulator, or the issuer. They are not affected by grades or grading processes, but for their reputation at stake. Since issuers bear the cost of processing the IPO Grading application, possibilities of a bias exist. Grading of IPOs will dissuade Small and Medium Enterprises (SMEs) as well as some established firms from floating IPOs. SMEs having poor fundamentals (and poor grade) may not find investors, while large and other firms belonging to established business houses will not accept any grade below their expectations. Such firms may defer their plans to float an IPO and opt for private placement, resulting in a lost opportunity for investors. According to Mr. Prithvi Haldea, Managing Director of Prime Database of the IPO market, "there are no incentives for the companies to rate their IPOs. First, there is no rating of IPOs anywhere in the world, and thus, there are no models. If a company accepts a particular rating, the concerned agency would have to report it to the SEBI and stock exchanges within the same month, which makes it public information. In such a case, a good company will not go for rating fearing that if it gets a bad rating, its issue may suffer despite strong fundamentals. Similarly, a bad company too would not go for rating, fearing that its cover-ups might get exposed with a poor rating" (Saha, 2006). The cost of raising funds has increased for issuers due to the added cost of grading for an IPO (The Economic Times, November 10, 2008).

❖ **Justification For IPO Grading :** Everybody does not oppose IPO Grading. Few are providing justification for IPO Grading. Jain and Sharma (2008) mentioned in their paper that if successful, it will further the aim of investor protection. Further, it will restrict the entry of low quality IPOs. Saha (2006) also enumerated positive features of IPO Grading. For one, it provides professional and independent appraisal by an expert and specialized agency. Two, it removes the information load since investors need not analyze the complex technical information themselves. Three, it also serves as an impediment for companies with poor-quality fundamentals. And fourth, it also improves investors' sophistication since they can make better informed investment decisions. This study evaluates investors' preference for graded IPOs using Demand Analysis. The findings suggest that Grading is directly correlated with demand. Further, the pattern of post-issue promoters' holding was also evaluated and was found to be inversely correlated with IPO grading.

This paper is divided into the following sub- parts. Introduction is followed by Conceptual Framework and Review of Literature. Thereafter, the objectives and hypotheses of the study are enlisted followed by research methodology, data analysis and results. Finally, the summary and conclusions arrived at are presented.

CONCEPTUAL FRAMEWORK

The Indian new equity issue market, commonly known as the IPO Market, is different from the rest of the world due to the number of investors involved. Typically, IPOs in India have three types of investor classes :

a) Retail Investors (with reservation of 30 to 35 percent) ;

b) Non-Institutional Investors (NII) or high net worth investors (with reservation of 10 to15 percent) and ;

c) Qualified Institutional Buyers (QIB) or the financial institutions, mutual funds, venture capitalists, etc. (with reservation of 50 to 60 percent). Apart from the above - mentioned investor classes, some IPOs do have some provisions for reservations and preferential allotment for their employees (usually limited to around 1 percent) and Anchor Investors (with reservation of 18 percent of the issue, within the QIB quota). The importance of retail investors can be judged from the fact that applications for this reserved one-third quota constitute nearly 99 percent of the total applications received for an IPO (based on the researchers' sample of 90 IPOs).

❖ **IPO Grading – The Concept :** The studies by Saha (2006) and Jain and Sharma (2008) deliberate at length on the conceptual issues of the IPO Grading. CRAs that are registered with SEBI assign the IPO Grading. Currently, there are five CRAs that are registered with SEBI. These are Brickwork Ratings (BWR), Credit Analysis Research Limited (CARE), CRISIL, FITCH Ratings, and ICRA Limited. While the first two CRAs are of Indian background, the last three are affiliates of renowned international organizations. CRAs assign grades to IPOs of equity shares or any other securities, which are convertible into or are exchanged with equity shares later. Grade represents a relative assessment of the fundamentals of that issue relative to other existing equity securities in India. IPO Grading is done on a five-point scale from the lowest score - 1 to the highest score - 5.

The lowest Grade 1 represents 'poor fundamentals'; Grade 2 represents 'below average fundamentals' ; Grade 3 represents 'average fundamentals'; Grade 4 represents 'above-average fundamentals' ; and the Grade 5 represents 'strong fundamentals'. Thus, a higher score signals stronger fundamentals and vice-versa (SEBI website). IPO grading evaluates the issuer company on multiple and broad parameters, ranging from current operations, potential growth, competitive strength, and financial position to management quality, corporate governance, and historical background.

LITERATURE REVIEW

IPO Grading, being a new concept, limited empirical reference is available on it. While most studies cover subscription (demand) uniformly, very few have covered the pattern of Post- Issue Promoters Holding (PIPH, henceforth) in IPOs. In almost all such studies, the correlation is with respect to underpricing. Saha (2006) studied the conceptual framework on IPO Grading, when it was just introduced. Poudyal (2008) in his working paper studied the efficacy of IPO Grading using regression analysis on 63 IPOs from April 2005 to November 2008. This study noted that subscription improves with improvement in grading. Another study involving 115 ungraded and 44 graded IPOs conducted during the period from April 2006 to August 2008 by Deb and Marisetty (2008) concluded that grading influences demand by retail investors. Khurshed et al. (2008) studied 251 IPOs inclusive of 47 graded IPOs listed on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) from 1999 until August 2008. They concluded that grading is more useful to institutional investors rather than for retail investors. Another conclusion given by this study was that the book-building process itself offers stronger signal for retail investors as compared to IPO Grading. Empirical results from the above available literature only suggest that the total demand (subscription) improves with improvement in grade. There are other studies which pertain to performance of certification backed IPOs. But underpricing remains the basis of almost all such studies. Only vague reference is available to justify the demand in such studies. The paper by Khanna and Palepu (2000) is touted to be the first such paper to address the issue of certification of IPOs in the Indian market (where institutional voids are observed) . They argue that in markets where there are voids in the product, labor and capital markets, firms organize as business groups to overcome institutional voids. Therefore, affiliation to a business group acts as a certification and firms affiliated to such business groups are valued higher than others. Similar other studies by Chemmanur and Fulghieri (1999), Allen and Faulhaber (1989), Grinblatt and Hwang (1989), Welch (1989) and Chemmanur (1993), Loughran and Ritter (2001), Carter, Dark, and Singh (1997), Megginson and Weiss (1991), Carter and Manaster (1990), Barry, et al. (1990), Lee and Wahal (2004) examined the role of underwriters and venture capitalists and their influence on performance. Empirical evidence by Sahoo and Rajib (2010), Rao (2002), Allen and Faulhaber (1989) and few others suggest positive relationship between PIPH and underpricing. Some of the studies enumerated above have included issue size as one of the variables, but no definitive results are available.

OBJECTIVES OF THE STUDY

The primary purpose of this study is as follows:

1) To find whether grading of IPOs is used as a basis of investment decisions by the retail investors; and

2) To find whether IPO grades affect the PIPH (issue size).

HYPOTHESES

In view of the first objective, the researchers undertook to do a subscription analysis to find the demand/ preference for the IPOs. Accordingly, the following hypotheses were framed :

❖ **Null Hypothesis (H_{01}) : Grading of an IPO has NO effect on Subscription.**

❖ **Alternate Hypothesis (H_{11}) : Grading of an IPO has a DIRECT relationship with Subscription.**

❖ **Assumptions:** The purpose of grading is to provide investors information on the strength of the fundamentals of the company. If this information is accepted by the investors, then there would be more demand for higher graded IPOs. This demand would be reflected in the increase in the level of subscription as the grade increases.

In view of the second objective, we use proportion of Issued Share Capital as the dependent variable for evaluating its relationship with IPO grades. PIPH is calculated as a proportion of share capital not issued. Accordingly, we have the following hypothesis:

❖ **Null Hypothesis (H_{02}) : Grading of an IPO has NO effect on Issued Share Capital/PIPH.**

❖ **Alternate Hypothesis (H_{12}) : Grading of an IPO has an INVERSE relationship with Issued Share Capital (or DIRECT relationship with PIPH).**

❖ **Assumptions:** IPO issuers with poor fundamentals would look forward to issuing maximum proportion of their total paid-up capital at the initial stage itself (leading to lowest levels of PIPH) since, as compared with current value, the future value of their stock would be lower (because of poor fundamentals). The case will be just opposite for IPO issuers with strong fundamentals. Therefore, it is expected that higher graded IPO issuers shall issue small proportion of their total paid-up capital initially and vice-versa. Therefore, the proportion of issued share capital shall have a negative or inverse relationship with IPO grades. In other words, PIPH shall have a direct correlation with IPO grades, the higher the grade, the higher shall be PIPH.

RESEARCH METHODOLOGY

Data on IPOs, closing prices, Index values was collected from the website of NSE. Subscription and issue size details were collated from the website of ICICI Direct and Prime Database.

❖ **Sample:** 224 IPOs hit the market in total from May 2007 to December 2010 through the book-building process. Of these, 6 (six) IPOs got withdrawn or cancelled. The remaining 218 IPOs included 101 graded IPOs. The selected sample for the study are 90 Graded IPOs, which were listed on the NSE. Therefore, the sample forms 89 percent of the total 101 IPOs, and 100 percent of those that were listed on the NSE from May 2007 to December 2010. Five IPOs that had grading from more than one credit rating agency were considered for their higher grade only.

❖ **Variables:** Data is analyzed for - **a)** Subscription to the IPO at the Overall level (OVERALL) as well as at the Retail (RETAIL), Non-Institutional Investors (NII) and Qualified Institutional Investors (QIB) level , and **b)** Issued Share Capital.

❖ **Methodology:** The data was collated for the above variables and measures of central tendency were obtained for the initial outcome. Pearson's Product of Movement Test for Correlation was applied to assess the correlation between IPO Grades and the respective variable. The outcome values of this test lie between 1 and -1, with 0 being neutral. Negative value of correlation signals an 'inverse' relationship, while the positive value signals 'direct' or parallel relationship. Thereafter, one-way ANOVA (analysis of variance) Test was applied to assess and substantiate the results of correlation and to test the hypotheses. Final inferences were drawn using correlation, where the null hypothesis was not rejected. Where the null hypothesis was rejected, paired t-test was used to derive the final inference.

Table 1: Oversubscription In Indian IPOs								
Subscribed	**Overall**		**Retail**		**NII**		**QIB**	
(Times)	**No's**	**(%)**	**No's**	**(%)**	**No's**	**(%)**	**No's**	**(%)**
Below 1	3	3	28	31	8	9	19	21
1 to 5	42	47	32	36	37	41	28	31
5 to 15	18	20	22	24	11	12	15	17
15 to 50	20	22	8	9	17	19	19	21
Above 50	7	8	0	0	17	19	9	10
Total	**90**	**100**	**90**	**100**	**90**	**100**	**90**	**100**
Mean	**14.24**		**5.81**		**27.80**		**17.57**	
NOTE: Mandatory Minimum Subscription required is 90 percent (at an overall level).								
Source: NSE								

DATA ANALYSIS AND RESULTS

The market shares of IPO Grades broadly were distributed equally among Below Average (BA), Average (A) and Above Average (AA). The 37 percent share of Average (A) (Grade 3) is the highest. This is followed by Below Average (BA) Grades (Grade 1 and Grade 2 collectively) at 33 percent. The share of Above Average (AA) Grades (Grade 4 and Grade 5 collectively) is the lowest at 30 percent.

a) Subscription (Demand) Analysis: The complete overview of oversubscription among the Indian IPOs is presented in the Table 1. In more than half of the cases, oversubscription remains below 5 times. Since the number of applicants in case of the retail investor category is very high; the oversubscription is skewed to the lower side. There is statutory requirement for subscription to an IPO. The IPO must be subscribed at least 90 percent (0.9 times) at the overall level. Oversubscription is calculated for the overall level and then for different investor classes. The rising trend - better the

Table 2: Subscription Analysis					
Subscription (Times)					
Grade	**IPOs**	**Overall**	**Retail**	**NII**	**QIB's**
1	6	2.78	2.79	7.85	1.27
2	24	7.20	4.55	19.08	4.09
3	33	11.29	4.98	22.66	14.25
4	25	25.91	7.94	43.25	37.25
5	2	35.68	17.32	83.77	36.91
Average	**18**	**14.24**	**5.81**	**27.80**	**17.57**
Std. Dev		20.24	8.15	41.99	28.61
Pearson's Product of Movement (Correlation)		**0.971**	**0.887**	**0.929**	**0.948**
ANOVA p-Value		**0.000****	**0.092#**	**0.019***	**0.000****
Null Hypothesis @ 5% confidence		**Reject**	**Reject**	**Reject**	**Reject**
T Test	**BA-A**		**0.318**		
	BA-AA		**0.025***		
	A-AA		**0.073#**		
#Significant at 10% confidence level.					
*Significant at 5% confidence level.					
** Significant at 1% confidence level.					
Source: Based on data collated from NSE					

grade, higher the oversubscription - is clearly visible across all categories. The NII Category has the smallest quota of 10 to 15 percent exhibit maximum exponential oversubscription trend, almost parallel to the overall trend. QIB Category contradicts general belief that they are not influenced by grades. The lower preference at lower grades compared with reasonably higher preference in higher grades is a surprise. The average oversubscription for Indian IPOs is of around 14.24 times. Statistically, the correlation coefficients of 97 percent signals towards a very strong positive correlation between IPO grades and oversubscription of IPOs at the overall level. Furthermore, the coefficient values of above 88 percent and higher also signal a strong positive correlation of each investor class with IPO grading (see Table 2). This proves that demand (subscription) increases as the grade increases. Oversubscription at the overall level for Grade 5 is highest at 35.68 times compared with the lowest of 2.78 times for Grade 1. A similar trend is visible in all investor classes.

The ANOVA p-value for all categories is significant at the 5 percent confidence level, with the exception being retail subscription, which is rejected only at 10 percent. Thus, the H_{01} is rejected confirming the relationship. However, the same cannot be said in case of retail investors with equal confidence. The p-value in detailed t-Test analysis in case of retail subscription is significant at the 5 percent confidence level only for relationship between Below Average (BA) and Above Average (AA) and at 10 percent confidence level in case of Average (A) and Above Average (AA). Therefore, we conclude that Grades do influence the demand for stocks, and consequently, the oversubscription. However, the extent of preference given by Retail investors towards IPO grades needs further study.

b) Issued Share Capital: The trend in Issued share capital is reflected in the Table 3. The descending trend in the Table is fully supported by a very strong negative correlation coefficient of 97 percent, signaling inverse relationship with grades . The average proportion of issued share capital for Grade 1 and Grade 2 is highest at 36 percent and 35 percent respectively, while it is the lowest for Grade 5 at 15 percent. The average issued share capital of Grade 3, Grade 4, and Grade 5 is well below the overall average of 26 percent. The Pearson's product of coefficient at negative 96.6 percent is a strong signal of an inverse relationship between Grades and the issued share capital. This concludes that with improvement in Grades, the proportion of issued share capital decreases. The ANOVA p-value also rejects the H_{02} at 1 percent, thus confirming the above outcome.

Table 3: Issued Share Capital Analysis

Grade	IPOs (No's)	Issued Share Capital (%)
1	6	35.67
2	24	35.40
3	33	23.71
4	25	18.59
5	2	15.00
Total	**90**	**26.01**
	Std. Dev	12.17
Pearson's Product of Movement (Correlation)		**-0.966**
	ANOVA p-Value	**0.000****
Null Hypothesis @ 1% confidence		Reject
** Significant at 1% confidence level.		
Source: Based on data collated from NSE		

SUMMARY AND CONCLUSION

Indian securities market regulator SEBI achieved a distinction of being the innovator of equity grading in the world. Grading of IPOs in India was made mandatory, effective from May 2007. This study analyzed 90 IPOs graded by different credit rating agencies to explore the effect of grading on subscription and issued share capital. The primary objective of IPO grading remains to guide retail investors for a better investment decision. Our results suggest positive correlation of IPO grades with oversubscription at overall level as well as at the investor class level. This signals that

investment decisions of all types of investors are influenced by IPO grades. These results only strengthen findings of all previous studies of Deb and Marisetty (2008), Poudyal (2008) and Khurshed, et al. (2008). Additional research is suggested to analyze the extent of preference given by retail investors to IPO grades. Results also suggest that demand increases with improvement in IPO grades among high net-worth, well-informed, investor categories, NII and QIB. This can be viewed as a signal to the acceptance and credibility of the IPO grading process. Findings of this study show that proportion of issued share capital of an IPO is negatively (inversely) correlated with IPO grading. Thus, at the initial period, lower graded IPO issuers tend to issue (offload) most of their total share capital and dilute their holding, while the better graded IPO issuers release only a small proportion of their total share capital. This has a direct bearing on the underpricing and performance of the respective stocks. A stock belonging to the fully diluted share capital may show less or reasonable underpricing initially (since supply would be greater or equal to the demand), but long-term performance may not be sustained. Contrary to this, a stock from a partially diluted share capital may deliver high underpricing initially (since the demand would be greater than the supply), and also ensure better long-term performance. This offers a scope for further research.

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